NORTHWEST ECONOMIC RESEARCH

Lon L. Peters, Ph.D.
President

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May 9, 2002

Mr. Gene Tollefson
Freedom of Information Act Officer
Mail Stop CIL-1
Bonneville Power Administration
Post Office Box 3621
Portland, Oregon 97208-3621

Re: Freedom of Information Act Request

DELIVERY VIA FACSIMILE: 503-230-3862

Dear Mr. Tollefson:

Pursuant to the Freedom of Information Act, I hereby request the following on behalf of the Public Generating Pool.

> Please provide a copy of the internal audit of options trading referenced in the article entitled "BPA Increases Derivative Exposure to Meet Load Demand" in the May 6, 2002 issue of *Clearing Up*, No. 1030 at pp. 7-9, especially at the top of page 9 (attached), including related statements of policy, whether previously publicly released or not, administrative staff manuals that implement the audit and related policies, and other related records.

I am willing to pay BPA's costs of locating, reviewing, and copying these documents. If you estimate that your costs will exceed $50.00, please let me know before proceeding.

I request that the information I seek be provided in electronic format if the documents are available in such format:

- on a personal computer disk (3.5") as Word 6, Word97/98, or WordPerfect 6/7 documents or in formats compatible with these programs; or

- via attachments in one of the above formats to e-mail at lpeters@pacifier.com.

Northwest Economic Research, Inc.
6765 S.W. Preslynn Drive, Portland, Oregon 97225-2668
503-203-1539 503-203-1569 (fax) lpeters@pacifier.com

The Public Generating Pool (PGP) does not intend to use this information for commercial purposes. The above confirmation regarding reimbursement of costs should not be interpreted to imply an agreement with BPA's legal theory about the applicability of the Freedom of Information Act to this particular request or any subsequent or prior request.

You may contact me at 503-203-1539 during normal business hours, if necessary, to discuss any aspect of this request. The signed original copy of this request is being sent via regular mail to the address above.

Thank you for your consideration of this request.

Sincerely,

Lon L. Peters

cc: Ray Kindley – Schwabe Williamson & Wyatt

Attachment

Continued from page 5

coal in economic dispatch orders, mainly to meet peak demand.

After decades of the take-or-pay regime, supply contracts are beginning to expire and a whole new class of potential buyers (independent power producers, industrial end-users and merchant aggregators) is emerging. The incumbents are wary of making the new investments in infrastructure to secure supplies, but everyone is beginning to realize that regional diversity of demand offers the opportunity to arbitrage both destination markets and pricing indexes.

This is where Baja comes in. The creation of a Baja market hub could establish an international pricing point for LNG. Companies like Sempra are counting on a US "sink" for the South American supplies, but Baja potentially opens a gateway to tap peak demand in Korea, Japan and China--or in the Pacific Northwest for that matter--and to move LNG to an intermediate or even baseload fuel source.

As all of these areas struggle to meet environmental commitments and retool electric generation for the modern era, an LNG commodity market looms as a promising answer to several problems at once. Even if it is not the fuel with the least environmental residue, it is far preferable to oil, diesel, and, to many people, nuclear power.

This is not an overnight development, to be sure. Political and economic factors exert unpredictable influences. The Mexican Supreme Court's recent decision to moot the electric restructuring policy could sink foreign investment opportunities. Stiff competition from Australian "brown coal" or Malaysian gas or possible new land-based natural gas pipelines from Asia might continue to push LNG to the far end of the dispatch queue.

But indications are that Japanese policies may encourage contract access by aggregators to underused utility LNG terminals, and the reformulation of upstream contracts may open the doors to new markets and newer supply regions.

Loren Cox, associate director of the MIT Center for Energy and Environmental Policy Research, who moderated the Pacific Rim energy workshop I attended, observed, "If suppliers can be convinced to share market risk, LNG markets could evolve rather quickly to include seasonally important supplies to the West Coast of North America. In view of historic LNG supply chains, it is still a big 'if'--but the prospects for such flexible arrangements are brighter than ever before."

The novel combination of disparate cultural and economic threads is commonplace here on the West Coast, where we can celebrate Cinco de Mayo with dim sum and sushi. Increasingly, though, the "crude cocktail" of international energy policies is being replaced with a much more refined sense of markets and is being driven by forces far different than those that propelled the US experimentation with restructuring ***[Arthur O'Donnell]***.

Watchwords

[14] Jack Haffey of NorthWestern Energy/Montana Power to Retire

After 30 years in the energy business, NorthWestern Energy LLC President John "Jack" Haffey plans to retire May 30. The Montana native spent most of his career at the former Montana Power. His last two years have been occupied with divesting MPC of its coal, oil and gas businesses and transforming its telecommunications company into TouchAmerica, as well as putting together NorthWestern's acquisition of the electric utility.

Haffey said he's pleased with the way things turned out and it's time to move on. "Thinking about all our changes, it's been gratifying to be part of that work," said Haffey, 56.

Haffey has not made any plans beyond his May 30 stop date. Having served eight years as a state senator, he said he might consider some sort of public service. At the moment, Haffey is just glad the acquisition is complete. "It was like being on a treadmill that was on high speed for two years," he said. "I'm looking forward to spending some time thinking about" what to do next ***[C. S.]***.

Supply & Demand

[15] BPA Increases Derivative Exposure to Meet Load Demand ■ *from [5]*

BPA dramatically increased its exposure to both put and call options between 2000 and 2001 as part of an augmentation program hedging strategy to meet demand for the current five-year load period, agency officials said.

During November and December 2000 and January 2001, when the options were written, "We were facing large deficits," said Steve Oliver, BPA VP of bulk power marketing. A lot of the augmentation hole had been filled by then. But for the rest, BPA examined possibilities that included market purchases, curtailment and new generation, as well as options.

BPA sold, or "wrote," both call and put options. Call options give the holder--in this case, a BPA customer--the right to buy a futures contract from the agency for a specified price (the strike price) within a specified period of time. Puts give the holder a right to sell a futures contract to BPA at a specified price within a specific period of time. Options, like other derivatives, are principally risk management tools, but they can also be used to speculate on the market.

"It looks like they are entering more speculative positions than they did the year prior," said one regional trader. "Unless it's part of a bigger hedging program, it

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could be viewed as taking on more risk." The trader added that this analysis could not be verified without more information about BPA's operations.

BPA's purpose in the market was to hedge, not to speculate, Oliver said. BPA had not previously been in a situation like the one it found itself in during early fiscal year 2001, he noted. "It was a one-time thing. We're not actively in the options market now," he said. But if the agency found itself in a similar situation, it's possible BPA would use the strategy again, Oliver said. Since the inventory supply is now set for the current period, a return to last year's conditions is not likely any time soon.

According to BPA's annual report, by the end of fiscal year 2001, BPA had written over 400,000 MWh worth of call options with an average strike price of $130.25/MWh, compared to only 30,000 MWh with an average strike price of $61.67/MWh for the fiscal year that ended Sept. 30, 2000. Written put options totaling over 10 million MWh with an average strike price of $41.66/MWh were outstanding as of Sept. 30, 2001, compared to 190,000 MWh outstanding with an average strike price of $64.84/MWh as of Sept. 30, 2000.

'It looks like they are entering more speculative positions than they did the year prior.'

Conversely, BPA's purchases of options from others were comparatively negligible.

Oliver said BPA collected a total of about $26 million in premiums for the put and call options it wrote. Enron was among the handful of partners involved in the trades, but it was not the principal one, which Oliver would not name but described as a large financial services firm that sells risk management products and trades energy. BPA has previously purchased risk management products from Morgan Stanley.

BPA's options expire "at various times through December 2005," according to the annual report. For now, the call options are not a problem, since no one is likely to exercise an option to pay BPA $130/MWh for power in the current market. As for the $41/MWh puts, Oliver said they fall into two main categories: one group that totals about 150 MW a year for the full five-year rate period and another group worth about 125 MW per year for the final three years--2004, 2005 and 2006.

Buyers of the first group of puts exercised their right to sell to BPA at $41/MWh in December 2001, while those who bought the second group will not decide whether to exercise their options until 2004. Even though BPA is paying above market rates for the first group, Oliver said he believes the puts are good in the long run, since they protect BPA from prices going above $41/MWh during the rate period for that chunk of power. If market prices end up averaging $30/MWh for the period, the deal will not have been good, he conceded, but such a conclusion cannot be made until the end of the rate period.

Oliver noted that BPA dealt only in physical options, as opposed to financial options. But he said that initially, BPA's policies and controls with respect to physical options were not well defined. However, "Whenever we bought or sold options, there were limitations. Standard market risk procedure is to manage options relative to value of risk."

Asked if BPA adhered to its risk management policies and procedures, Oliver said: "We constantly reviewed it and worked with the risk management team and executive group when prices changed radically. We worked together to change the limits."

Sanford Menashe, BPA Manager of Back Office Operations, said it is important to look at the "whole book" of trades. In some cases, BPA is paying above market, he conceded, "but relative to the situation with respect to what everyone else is doing, we are pretty pleased with the way we sit."

Oliver pointed out that these positions represented only a small portion of the 2000 aMW BPA purchased in its augmentation program, which he said cost an average of $35/MWh. He added that BPA is comfortable with its positions: "I'd stand [our] portfolio up over anyone else in the West." BPA obtained a good share of its augmentation needs before the run-up in prices, and reduced a large amount of the unanticipated load demand with buy-backs and other load reduction strategies for which it paid relatively good prices, he said.

The option deals have implications for the load-based cost recovery adjustment clause (LB CRAC) that BPA uses to adjust rates every six months. "The treatment on value for these is complicated and it's got to be placed in the LB CRAC appropriately," Oliver said. He noted that due to the timing of the writing and exercising of the options, accounting for their impacts could not be factored into the first two six-month adjustment periods under the current rate period, but could be by the time the LB CRAC for the third period, starting Oct. 1, 2002, is calculated. He said BPA officials

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discussed with customers the complicated issue of how to value the options to include their outcomes in the CRAC at a workshop in February, and that it was still "a work in progress."

PricewaterhouseCoopers (PwC), BPA's auditor, gave the agency a clean audit for its 2001 financial statements. The auditor noted that BPA, like a number of other organizations, changed its method of accounting for derivative instruments starting Oct. 1, 2000, when it adopted a FASB ruling. Statement 133, which amended procedures for "accounting for derivative instrument and hedging activities," requires that every derivative instrument be recorded on the balance sheet as an asset or liability at fair value and that changes in value be recognized in earnings.

PwC did not return phone calls seeking comment.

According to its annual report, BPA "records written options on a mark-to-market basis and includes gains and losses in operating revenues" in its Statement of Revenues and Expenses. One observer said that means BPA will at least disclose whether it is "in or out of the money"; that is, losing or gaining on its options in a timely fashion. Unlike accrual accounting, MTM accounting assigns a value for derivatives as of a certain date, even though that value may change as instruments play out over time.

As of Sept. 30, 2001, the options represented a loss to BPA over the five-year rate period of about $80 million on a mark-to-market basis, the agency said. But by March 31, with market prices on the rise, the loss figure was closer to $28 million.

BPA did an internal audit of the options trading, but declined to release that report. Oliver said BPA wanted to do "a self-assessment. We all felt like the control in terms of our decision-making and review of options could be improved and we worked to improve them." He said BPA was making changes before the audit was done.

One of the principal changes is how strategic decisions to enter into options are documented. "We were doing a lot of transactions last year in terms of augmentation," Oliver said. "Looking back, everyone would like to have more time and ability to do analysis." A lot of last year's transactions were analyzed and approved verbally by the trading floor manager, leaving only secondary records to verify transactions. "The conclusion was, we needed to do that more formally," Oliver said.

To that end, BPA has signed up for the KW3000, a software product described by its vendor, KWI, as "a suite of integrated applications designed to manage risk and trading" that handles "complete front-to-back-end trading, scheduling, delivery and risk management." BPA has also taken steps to beef up various other aspects of its risk management capabilities, and senior management has embarked on a "risk management project," said spokesman Ed Mosey. The agency feels it "needs to be up to speed on risk management in general, and on how the agency might use it" ***[Ben Tansey]***.

Courts & Commissions

[16] PacifiCorp Files at FERC; Tacoma Intervenes in Other Cases ■ *from [1]*

PacifiCorp has filed complaints with the Federal Energy Regulatory Commission, claiming the rates included in power purchase contracts the IOU signed last year with five power suppliers are "unjust and unreasonable or are contrary to the public interest." In addition, the company wants FERC to reset the contract prices to a rate that is closer to the prices now being charged for power delivered from July 1, 2002 through Sept. 30, 2002.

The five complaints, filed May 2, cover contracts the company signed with El Paso Merchant Energy, Williams Energy and Marketing, Morgan Stanley Capital Group, Enron Power Marketing and Reliant Energy Services between April 18, 2001 and June 14, 2001--before FERC's June 19 adoption of a West-wide market mitigation policy, which capped wholesale market prices through Sept. 30, 2002. PacifiCorp's claims involve forward contracts for power to be delivered this summer, for which the company paid between $120/MWh and $262/MWh.

PacifiCorp's complaint differs from others already filed at FERC regarding unjust and unreasonable prices. While most of those relate to multi-year transactions, PacifiCorp's "contracts were all signed in the period leading up to the [FERC] price cap and cover just the summer [2002] months," said spokesman Dave Kvamme.

Prior to signing the contracts, PacifiCorp had urged FERC to set temporary price caps in order to control last year's volatile Western market prices, the company pointed out. At the time, FERC maintained it would not set such price controls and urged utilities to buy forward to avoid the volatile market, according to PacifiCorp. As a result, the utility entered into contracts it now wants to revise.

"**The policy issues are different** for contracts such as the summer 2002 90-day contracts because the commission has already changed the buyers' (such as PacifiCorp) contractual expectations by imposing the West-wide cap for the full term of the summer 2002 90-day contracts," PacifiCorp states in its filing.

Unlike other long-term contract complaints FERC has agreed to consider, "there is virtually no possibility that PacifiCorp's...contracts--which all call for delivery during the price mitigation period--will ever be 'economic'," the company also states. "Long-term arrangements may ultimately prove to be economic because

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Department of Energy

Bonneville Power Administration
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SHARED SERVICES

May 10, 2002

In reply refer to: CILR/4

Mr. Lon L. Peters
Northwest Economic Research
6765 S.W. Preslynn Drive
Portland, Oregon 97225

Dear Mr. Peters,

Thank you for the letter of May 9 requesting documents under provisions of the Freedom of Information Act. The request has been logged in as #02-026.

Specifically, you asked for "a copy of the internal audit of options trading "referenced in the article entitled "BPA Increases Derivative Exposure to Meet Load Demand" in the May 6, 2002 issue of Clearing Up, No. 1030 at pp. 7-9, especially at the top of page 9 (attached), including related statements of policy, whether previously publicly released or not, administrative staff manuals that implement the audit and related policies, and other related records.

You indicate a willingness to pay costs of locating, reviewing, and copying documents, but ask that if estimated costs exceed $50 we call you before proceeding.

You further asked that the documents be provided in electronic format, on personal computer disk (3.5) as Word 6, Word 97/98, or WordPerfect 6/7 documents or in formats compatible with these programs; or via attachments in one of the above formats to e-mail at lpeters@pacifier.com.

Mr. Michael R. Sparks, Manager, Audit, has been designated as Authorizing Official for your request. Mr. Sparks has 20 working days, until June 10, to provide a response. Should you have any questions he may be reached at Mail Stop/DN-7 or by calling 503-230-4135.

Sincerely,

Gene Tollefson

Gene Tollefson
Freedom of Information Officer

bcc:
G. Tollefson - CI/4
M. Sparks - DN-7
M. Nelson - A/7
J. Bennett - LC/7
P. Mautner - LC/7
C. Jacobson - LC/7
Official File - CILR (EX 13-13, 02-026)

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